

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:BRK:TL-N-5710-99

TKerrigan

NOV 30 1999

date:

to: Chief, Examination Division
Attention: Manager Group 1213 - Income
E:E:F:1213

from: District Counsel
Brooklyn CC:NER:BRK

subject:

EIN: [REDACTED]
Taxable year [REDACTED]
U.I.L. Nos. 0469.01-01, 1234.01-01

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This memorandum is in response to your request for advice, dated September 16, 1999, concerning the proper characterization of income received by the above-named trusts from the holder of an option to purchase residential rental property owned by the trusts.

FACTS

The relevant facts, as we understand them, are as follows: Forms 1041, U.S. Income Tax Return for Estates and Trusts filed by [REDACTED] and [REDACTED] for the [REDACTED] taxable year were selected for audit by the examination division. Each trust was the owner of a [REDACTED] interest in a residential rental property located at [REDACTED]. On [REDACTED], the trusts entered into a lease agreement for a term of [REDACTED]. The rent for the term was \$ [REDACTED]. Paragraph [REDACTED] of the lease agreement contained an

option to purchase clause. Pursuant to the terms of the option, the holder of the option delivered a bank check in the amount of \$ [REDACTED] at the time of execution of the lease and had until [REDACTED] to exercise the option to purchase the real property for a fixed purchase price of \$ [REDACTED]. The agreement provided that the amount paid for the option was nonrefundable should the option holder fail to exercise the option. The agreement further provided that if the option was exercised and the sale consummated, the holder would receive a credit towards the purchase price. The option holder failed to exercise the option under the terms of the agreement. Each trust reported \$ [REDACTED] from the expired option on their [REDACTED] tax return and characterized the income as passive income. The trusts used this income to offset \$ [REDACTED] of suspended passive activity losses from earlier tax years. In the following tax year, the trusts transferred the [REDACTED] property in a like-kind exchange to the holder of the expired option and received rental property in [REDACTED] with a fair market value of \$ [REDACTED]. Based on the information provided, it appears that the trusts also gave the purchaser a credit of \$ [REDACTED], the amount of the option to purchase, in the like-kind exchange.

ISSUE

What is the appropriate characterization of the payment received by the trusts for Federal income tax purposes based upon the transaction described above?

LEGAL ANALYSIS

I.R.C. § 469(a)(1) provides generally that any passive activity loss claimed by a taxpayer during any taxable year is not allowable as a deduction. I.R.C. § 469(a)(2) includes "any individual, estate or trust" in the definition of persons for whom the passive activity loss limitations apply. I.R.C. § 469(c)(2) further provides that "passive activity" includes any rental activity. I.R.C. § 469(j)(8) defines a rental activity as any activity where payments are principally for the use of tangible property. I.R.C. § 469(d)(1) generally provides that the term "passive activity loss" means the amount, if any, by which (A) the aggregate losses from all passive activities for the taxable year exceed (B) the aggregate income from all passive activities for such year. Therefore, the general rule of I.R.C. § 469 is that passive activity losses can be offset only by passive activity income and cannot be deducted against interest,

dividends, and other portfolio income.^{1/} In the present case, each trust reported the income received from the expired option on Form 8582, Summary of Passive Activities Worksheet for purposes of offsetting prior year unallowed losses and claimed a passive activity loss in the amount of \$ [REDACTED] for the [REDACTED] taxable year.

In the present case, the trusts attempted to create passive income during the [REDACTED] taxable year in order to trigger their considerable suspended passive loss deductions by characterizing ordinary income as passive income. We further note that the property at issue was transferred in a like-kind exchange to the option holder in the following year after the forfeiture of the option. In that subsequent transaction, it appears that the trusts, the option grantor, gave the purchaser a credit in the amount of \$ [REDACTED].^{2/} Therefore, the trust treats the option to purchase as having expired in accordance with the terms of the agreement for purposes of attempting to create passive income for the [REDACTED] taxable year and at the same time treats the option to purchase as having been exercised in the [REDACTED] like-kind exchange.

The amount received upon the expiration of the option does not represent I.R.C. § 469(j)(8) rental income because the expired option is not a payment principally for the use of tangible property. Options can be property in their own right and may be disposed of in transactions unrelated to their exercise. Treas. Reg. § 1.469-2T(c)(2)(D), Example (3), indicates that if an option to acquire property gives rise to

^{1/} Two exceptions to the general rule, neither of which is applicable in this instance, are provided in I.R.C. § 469(i) and I.R.C. § 469(c)(7). I.R.C. § 469(i) allows a deduction of passive activity loss in excess of passive activity income in any taxable year in an amount not to exceed \$25,000 in the case of an individual with respect to losses attributable to rental real estate activities in which the individual actively participated. This exception phases out, in certain circumstances, where the taxpayer's adjusted gross income exceeds \$100,000. See I.R.C. § 469(i)(3). There is no \$25,000 offset, however, for rental real estate held by a trust. I.R.C. § 469(i)(1) provides that only "natural persons" may use the \$25,000 offset. For tax years after 1993, I.R.C. § 469(c)(7) also provides that individuals and closely-held C corporations are not automatically subject to the passive activity loss rule if they satisfy certain eligibility and material participation requirements.

^{2/} The original option to purchase listed the sale price as \$ [REDACTED]. In the like-kind exchange the purchase transferred property with a fair market value of \$ [REDACTED]. In addition, the purchaser received a \$ [REDACTED] credit to reflect the \$ [REDACTED] option payment made under the option to purchase agreement.

income in such a disposition, the income will not be generated by the underlying activity that the property is used in. Here, the taxpayer's gain on the lapse of the option to acquire the rental property is unrelated to the underlying rental activity. Therefore, the gain cannot be treated as generated by the underlying passive activity. The gain on the lapse of the option is similar to portfolio income. The legislative history of I.R.C. § 469 indicates that portfolio income should not be included in passive activity gross income because portfolio items generally are positive income sources that do not bear, at least to the same extent as other items, deductible expenses. See Tax Reform Act of 1986, Senate Report No. 99-313, reprinted in 1986-3 C.B. (Vol. 3) 719. The premium received for an unexercised option will represent a positive income source without deductible expenses. Therefore, the income generated on the lapse of an option should also be treated as portfolio income (assuming the taxpayer is not in the trade or business of granting options). Having determined that the income is nonpassive, there remains both a characterization and timing issue with respect to the option to purchase. Therefore, there are two possible outcomes depending on whether it is concluded that the option lapsed in [REDACTED] or was exercised in [REDACTED].

An option to purchase is an agreement that gives a party a right to purchase property at a fixed price within a specified period of time. Koch v. Commissioner, 67 T.C. 71, 82 (1976), acq., 1980-2 C.B. 1. Option payments are not taxed until the option lapses or is exercised, because the tax consequences of the payments are not known before then. Virginia Iron Coal & Coke Co. v. Commissioner, 99 F.2d 919, 921 (4th Cir. 1938), cert. denied, 307 U.S. 630 (1938); Dill Company v. Commissioner, 33 T.C. 196, 200 (1959), aff'd, 294 F.2d 291 (3d Cir. 1961); Koch v. Commissioner, 67 T.C. at 86-88. I.R.C. § 1234 provides for the tax treatment of gains and losses attributable to options to buy or sell property. Pursuant to this code section, gain or loss from the sale, exchange or loss from the failure to exercise an option to buy or sell property to the option holder is considered to be gain or loss from the sale or exchange of a capital asset, if the property that is the subject of the option is a capital asset in the hands of the holder of the option. Treas. Reg. § 1.1234-1(b) states that any gain to the grantor of an option arising from the failure of the holder to exercise it is ordinary income. Accordingly, the option payment is taxable as ordinary income in the year the option lapses. Virginia Iron Coal & Coke Co. v. Commissioner, 99 F.2d at 921; Ingram v. Commissioner, T.C. Memo. 1961-277, remanded, 63-2 USTC ¶ 9516 (5th Cir. 1963); Usher v. Commissioner, T.C. Memo. 1980-180. If the option is exercised, however, the option payment is considered to be part of the purchase price of the property and subject to capital gains treatment in the year the option is

exercised and where the underlying property is a capital asset in the hands of the taxpayer. Treas. Reg. § 1.1234-1(a).

Additional facts need to be developed to determine whether the transaction was closed when the option holder let the option expire without exercising it thereby fixing the nature of the payment for the option as ordinary income in [REDACTED] or whether the time to exercise the option was extended by the parties to the following year. As noted above, the purchaser appears to have received a credit in the amount of \$[REDACTED] and exchanged property with a fair market value of \$[REDACTED] in the [REDACTED] transaction. Therefore, if purchaser did in fact receive the credit, the purchaser essentially obtained the [REDACTED] property at the \$[REDACTED] option to purchase sales price.

We note that the proper accounting of the expired option credit with respect to the like-kind exchange will potentially have significant Federal income tax consequences to the trusts. Under I.R.C. § 1001(a), the gain or loss on a sale or other disposition of property is the difference between the amount realized from the transaction over the adjusted basis provided in I.R.C. § 1011. No gain or loss is recognized, however, if property held for productive use in a trade or business or for investment (not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest) is exchanged solely for property of a like-kind to be held either for productive use in a trade or business or for investment. I.R.C. § 1031. Pursuant to I.R.C. § 1031(b) if an exchange would be within the provisions of subsection (a) if it were not for the fact that the property received in exchange consists not only of property permitted by such provision to be received without recognition of gain, but also other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property. Therefore, gain is recognized in a transaction, which otherwise qualifies under I.R.C. § 1031 if, in addition to nonrecognition property, the taxpayer receives other property, commonly called "boot". If property was acquired in an I.R.C. § 1031 exchange, then the basis shall be the same as that of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized on such exchange. I.R.C. § 1031(d). However, we believe there may be an issue as to whether the \$[REDACTED] payment constitutes boot under the circumstances presented in this case because it is unclear whether the payment was received in the exchange. See Fredericks v. Commissioner, T.C. Memo. 1994-27. The stated facts suggest the payment was made to secure the option in [REDACTED] and was

fully payable in that year when the option lapsed. Further, the facts indicate that the amount was reported by the taxpayers as income in the [REDACTED] taxable year. Thus, despite the characterization of the \$ [REDACTED] payment as a credit, it does not appear to have been made as part of the exchange in [REDACTED].

An exchange of a taxpayer's interest in a passive activity in an I.R.C. § 1031 nonrecognition transaction, generally does not trigger suspended passive activity losses. I.R.C. § 469(g). However, to the extent that the taxpayer recognizes gain on the transaction (for example, to the extent of boot received), the gain is treated as passive activity income, against which passive losses may be deducted. See Tax Reform Act of 1986, Senate Report No. 99-313, reprinted in 1986-3 C.B. (Vol. 3) 726-727. Therefore, if the expired option credit was treated as "boot" in the subsequent like-kind transaction, the trusts may be entitled to claim a passive activity loss for the [REDACTED] taxable year, the year in which the exchange of the property took place. While boot is considered passive income, any remaining suspended losses would remain suspended until the taxpayer makes a complete disposition of the newly acquired property.

CONCLUSION

Based on the above, there is both a characterization and timing issue with respect to the option to purchase. Therefore, there are two possible results depending upon the appropriate treatment of the option amount. First, if the option had expired in [REDACTED], each trust is required to recognize ordinary non passive income in the amount of \$ [REDACTED] under Treas. Reg. § 1.1234-1(b) in that tax year. Second, if the option was extended by agreement of the parties and exercised in [REDACTED], the option would be treated as boot in the like-kind exchange transaction, which would result in a deduction for suspended passive losses in the [REDACTED] taxable year. We recommend that you obtain a copy of the sales contract and all other relevant documents relating to the like-kind exchange and any negotiations relating to any extension of the option to purchase. This information will provide the requisite factual information to conclude whether the option amount was forfeited by the option holder thereby creating ordinary income for the trusts in [REDACTED] or whether the original option was extended and subsequently exercised in [REDACTED]. In addition, facts should be obtained concerning the parties' computations of basis and the buyer's treatment of the \$ [REDACTED] payment.

This opinion is based upon the facts set forth herein. It might change if the facts are determined to be incorrect. If the facts are determined to be incorrect, this opinion should not be

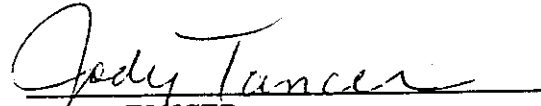
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relied upon. If you have any questions or require further assistance, please contact Thomas Kerrigan at (516) 688-1742.

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